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Ramzi Nasser

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# THE MORALITY OF INSIDER TRADING IN THE UNITED STATES AND ABROAD

RAMZI NASSER\*

## I. Introduction

In the United States, corporate insiders can face hefty fines and prison sentences for trading securities on the basis of inside information. The Supreme Court has determined that such practices take "unfair advantage" of stockholders.<sup>1</sup> This focus on injustice highlights the ethical issues raised by insider trading. Regardless of whether such trading is efficient, many theorists who examine trading in the United States have shored up the "intuition" that insider trading is "just not right."<sup>2</sup>

In other countries, however, the reaction to insider trading has not been as strong. Though many countries are beginning to pass laws against insider trading, prosecutions and punishments have occurred rarely, if ever. One textbook has noted, for example, that "most Japanese do not consider insider trading immoral."<sup>3</sup> In fact, while the United States has long prosecuted and imprisoned those found guilty of insider trading, Japan did not impose a penalty of imprisonment for such an offense until August 1997.<sup>4</sup> Similarly, insider trading has been considered a punishable criminal offense in Canada since the late seventies,<sup>5</sup> but few prosecutions ever occur, and only one individual has received a prison sentence for insider trading.<sup>6</sup> In fact, insider trading seems to go largely unpunished in Australia, France, Germany, and Mexico, even though the practice is also illegal in those countries.<sup>7</sup>

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\* J.D., University of Pennsylvania; B.A., University of California, San Diego. Clerk for the Honorable James T. Giles, Chief Judge of the Eastern District of Pennsylvania. Unending gratitude to Leo Katz, Joe Farber, Peter Huang, and Craig Green for their immense help with this project.

1. *Chiarella v. United States*, 445 U.S. 222, 228-29 (1980) (quoting *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (Del. 1951)).

2. Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, LAW & CONTEMP. PROBS., Summer 1993, at 123, 123.

3. JAPANESE SECURITIES REGULATION 192 (Louis Loss et al. eds., 1983) [hereinafter JAPANESE SECURITIES].

4. See *Ex-lawyer Gets Suspended Term for Insider Trading*, JAPAN WEEKLY MONITOR, Aug. 4, 1997. Not all theorists agree that Japan has not prosecuted insider trading cases because the practice is not considered immoral. For example, George F. Parker thoughtfully argued that the main reason for lack of prosecutions was the Japanese government's collusive ties with corporations. See George F. Parker, *The Regulation of Insider Trading in Japan: Introducing a Private Right of Action*, 73 WASH. U. L.Q. 1399, 1417-18 (1995); see also Dan Fenno Henderson, *Securities Markets in the United States and Japan*, 14 HASTINGS INT'L & COMP. L. REV. 263, 288-89 (1991) (arguing that the Japanese government and Japanese corporations conspire to gain advantages over foreign companies).

5. See Edward Rosenbaum et al., *Corporate and Investment Attitudes Toward Insider Trading in Canada*, 484 CAN. BUS. L.J. 485, 485 (1983-84).

6. See Scott Haggert, *Unearthing Insider Trading: Endless Task for Regulators*, FIN. POST, Apr. 13, 1995, at 26.

7. See Harvey L. Pitt & David B. Hardison, *Games Without Frontiers: Trends in International*

Many countries that have passed laws against insider trading were following the example of the United States or responding to United States pressures. One might expect that if it is morally wrong for an insider to trade on privileged information in the United States, the moral norm would also exist in other countries. This article attempts to account for the fact that nations other than the United States have been ambivalent about punishing insider trading. It focuses on comparing the United States and the nations of Japan and Canada, whose markets are similar to the United States Securities market.<sup>8</sup> I hypothesize that structural factors within the securities markets of Japan and Canada make "United States conclusions" about the moral and criminal implications of insider trading inapplicable, and make severe criminal sanctions inappropriate.

The analysis focuses on the quintessential and most obviously illegal forms of insider trading — when a high level corporate official buys or sells stocks in the company she works for based on unreleased information she obtained in the course of her work. Discussion of more complex insider trading liability, such as "tipping liability" and "liability based on misappropriation" will have to be saved for another project.<sup>9</sup>

Part II of this article recounts the laws against insider trading in the United States, Japan, and Canada, and shows how severe criminal punishments have not occurred in the latter two countries even though insider trading is both illegal and widely practiced in those countries. Part III argues that most economic theorists miss the point regarding insider trading prohibitions. Specifically, this article contends that insider trading has been outlawed in the United States primarily because the practice is considered immoral. Thus, when determining if offenders should face criminal sanctions, foreign countries must determine whether insider trading in those countries is as immoral as it is in the United States. To this end, Part IV explains how insider trading may not be as immoral in Canada and Japan as it is in the United States. The relationship between a corporate insider and a stockholder may include fewer fiduciary duties (of insiders to shareholders) in Japan and Canada, mostly because the relationship revolves less around disclosing information than it

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*Responses to Insider Trading*, LAW & CONTEMP. PROBS., Autumn 1992, at 199, 207-22.

8. I consider these countries similar to the United States for different reasons. Japanese securities markets are similar in size to United States securities markets. The Tokyo Stock exchange is "the only stock market in the world whose size rivals that of the United States." Larry Zoglin, *Insider Trading in Japan: A Challenge to the Integration of the Japanese Equity Market to the Global Securities Market*, 1987 COLUM. BUS. L. REV. 419, 421 (1987). Canada and the United States, as neighbors, do not have cultural differences so vast that they would cause profound differences in the way trading occurs in the two countries.

9. "Tipping liability" refers to when an insider tips someone else about confidential information and that person proceeds to trade on that information. The Supreme Court of the United States has found both the "tipper" and the "tippee" to be liable under insider trading laws. *See* *Dirks v. SEC*, 463 U.S. 646 (1983). Misappropriation, quite roughly, refers to when a non-insider steals information from an insider. The Second Circuit has applied this theory since the early eighties. *See, e.g., United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984). The Supreme Court applied the misappropriation theory for the first time only recently. *See United States v. O'Hagan*, 521 U.S. 642 (1997).

does in the United States. Further, stockholders in Japan and Canada are more likely to have access to supposedly "privileged" information than stockholders in the United States. Thus, when insiders trade with privileged information, it is less likely to be unfair to stockholders since the shareholders may have access to the same information.

I hope these conclusions will shed light on the appropriateness of insider trading laws in individual countries as well as help account for the lack of enthusiasm in other countries regarding continued United States pressures to step up prosecutions and criminal sanctions for insider trading.

## *II. Prohibiting Insider Trading: The Law and the Facts About Insider Trading in the United States, Japan, and Canada*

Insider trading has long been illegal in the United States. People who are found guilty of the offense — and they often are<sup>10</sup> — are subject to a maximum sentence of ten years in prison.<sup>11</sup> Following the United States example, Japan and Canada have also adopted provisions outlawing insider trading, but actual enforcement of these criminal sanctions has not followed.

### *A. The Anti-Fraud Statute in the United States*

In the United States, criminal liability for insider trading arises from the Securities and Exchange Act of 1934.<sup>12</sup> Section 10(b) of the Act makes it a crime to trade "in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe."<sup>13</sup> Rule 10b-5 specifically provides that it is unlawful

(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purpose or sale of any security.<sup>14</sup>

The United States Supreme Court has found guilt under Rule 10b-5 when the following two requirements are present: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that inside information by trading without disclosure."<sup>15</sup>

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10. See JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS AND POLICY* 6 (1991) [hereinafter MACEY, *ECONOMICS*].

11. See Insider Trading and Enforcement Act of 1988, 15 U.S.C. § 78ff(a) (1994).

12. 15 U.S.C. § 78j (1994).

13. *Id.* § 78j(b).

14. 17 C.F.R. § 240.10b-5 (1998).

15. *Chiarella v. United States*, 445 U.S. 222, 227 (1980). This is the main theory of insider trading

Those found guilty of insider trading are often imprisoned for long periods of time.<sup>16</sup> The United States has a reputation for exercising what some have called "excessive prosecutorial zeal" when it comes to insider trading.<sup>17</sup>

## B. Insider Trading in Japan

### 1. Legal Prohibitions

Surprisingly, Japan has had insider trading provisions as part of its code nearly as long as the United States. In 1948, Japan adopted the Securities and Exchange Law (SEL)<sup>18</sup> using American securities laws as a model.<sup>19</sup> Much like the United States' Rule 10b-5, Article 58 of the SEL provides:

[N]o person shall (1) employ any fraudulent, scheme or artifice with respect to buying, selling or other transactions in securities; (2) obtain money or other property by using documents or any other representations which contain a false statement with respect to a material fact, or omit representation of a material fact which is necessary in order to make such statements made not misleading; (3) make use of any false quotation for the purpose of inducing the purchase or sale or other transactions in securities.<sup>20</sup>

Though most commentators agree that the provision is best interpreted to cover insider trading practices, the Japanese have never used this provision to prosecute insider trading.<sup>21</sup> Japan's Ministry of Finance claimed that Article 58 did not cover insider trading.<sup>22</sup> Much like Rule 10b-5, Japan's Article 58 is "abstract, broad, and flexible" and theorists have agreed that it would be appropriate to use the Article to meet "new and innovative attempts to evade the law."<sup>23</sup> Nonetheless, Japanese officials have not embraced this flexibility and have only applied the statute in a single case since its inception. The case did not involve insider trading.<sup>24</sup>

Though Japan has not made use of its anti-fraud statute, there are still other legal provisions that purport to prohibit insider trading. The Ministry of Finance has issued an ordinance that does not allow corporate insiders to trade on confidential

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that the Supreme Court has accepted. The Court recently adopted the misappropriation theory also. See *infra* note 117. It is too soon to judge the reception of this theory in the United States and abroad and, thus, it is not the focus of this article.

16. See, e.g., *SEC v. Boesky*, No. 11288, 1986 WL 15283 (S.D.N.Y. Nov. 14, 1986); MACEY, *ECONOMICS*, *supra* note 10, at 16.

17. Pitt & Hardison, *supra* note 7, at 199.

18. See Shoken torihikiho [SEL] Law No. 25 of 1948 (Japan). The translations of Japanese law in the article are all from Tomoko Akashi, *Regulation of Insider Trading in Japan*, 89 COLUM. L. REV. 1296 (1989).

19. See Akashi, *supra* note 18, at 1297-98.

20. SEL Law No. 25 of 1948, art. 58 (Japan), translated in Akashi, *supra* note 18, at 1298 n.11.

21. See Akashi, *supra* note 18, at 1298.

22. See *id.*

23. *Id.* at 1313.

24. See *id.* at 1298 n.14.

information they obtained in the course of their employment.<sup>25</sup> However, if employees violate this provision, they are not subject to the criminal sanctions one would expect for acts which citizens consider unethical.<sup>26</sup> Instead, violation of this ordinance result in administrative sanctions such as suspension of business,<sup>27</sup> cancellation of a license,<sup>28</sup> or cancellation of the registrations of a business' representatives.<sup>29</sup> Furthermore, Japanese officials have not once invoked these penalties.<sup>30</sup>

Based on domestic and foreign criticism of rampant unpunished insider trading, Japan amended its insider trading laws in 1988.<sup>31</sup> Article 188 of the SEL was amended to require a "director or principle shareholder" to file a report of his transaction when he "purchases or sells . . . on his account any stock, convertible bond, bond with warrant, warrant or option thereof of [his] corporation."<sup>32</sup> If this report is filed inaccurately, or is not filed at all, the trader is subject to a fine of up to 300,000 yen (approximately U.S.\$2700).<sup>33</sup> Once this filing is made, corporations and shareholders suspecting improprieties will be able to bring an action against the insider to surrender the profits she made to the corporation.<sup>34</sup>

Also in 1988, Japan finally enacted workable penal sanctions for insider trading by amending the Securities and Exchange Law of 1948 to include articles 190-2, 190-3, and 200.<sup>35</sup> Article 190-2 proscribed the sale or purchase of securities if the "corporate-related parties" had obtained "material facts" about a security through their relationship to their corporation and the material facts had not yet been disclosed to the public.<sup>36</sup> Article 190-3 extends the prohibition to trades of another corporation's securities when the insider's corporation is in the process of making a "tender offer" to acquire the corporation whose securities are traded.<sup>37</sup> Finally, Article 200 provided for a criminal penalty of up to six months in prison<sup>38</sup> or as much as a 500,000 yen (approximately U.S.\$4500) fine for a violation of Article 190-2 or 190-3.<sup>39</sup>

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25. See *id.* at 1299 (citing Shoken gaisha no kenzensei no junsokuto ni kansuru shorei [Soundness Ordinance], MOF Ordinance no. 60 of 1965, art. 1 item (5) (Japan)).

26. See *infra* Part III for a discussion of the connection between immoral acts and criminal provisions.

27. See Akashi, *supra* note 18, at 1299 n.22 (translating SEL Law No. 25 of 1948, art. 35 (Japan)).

28. See *id.*

29. See *id.* (translating SEL, Law No. 25 of 1948, art. 64-3) (Japan)).

30. See *id.* at 1299.

31. See *id.* at 1302-03.

32. *Id.* at 1304 n.54 (translating SEL Law No. 25 of 1948, art. 188 (as amended 1988) (Japan)).

33. See *id.* at 1305 (citing SEL Law No. 25 of 1948, art. 205 item (14-2) (Japan)).

34. See *id.* at 1305 & 1299 n.23.

35. See *id.* at 1306.

36. *Id.* (citing SEL Law No. 25 of 1948, art. 190-2 (as amended 1988) (Japan)).

37. See *id.* at 1309 (citing SEL Law No. 25 of 1948, art. 190-3 (as amended 1988) (Japan)).

38. See *id.* at 1306 (citing SEL Law No. 25 of 1948, art. 200 (as amended 1988) (Japan)).

39. See *id.*

In recent years, Japan has begun to police insider trading more closely.<sup>40</sup> As part of the Securities Fairness Act of 1992,<sup>41</sup> Japan created the Securities and Exchange Surveillance Commission (SESC) to serve as a "watchdog" to uncover non-compliance with securities regulations.<sup>42</sup> The SESC has the power to investigate suspected inside dealing and the duty to report such wrongdoing to the Ministry of Finance.<sup>43</sup> At first glance, the Commission seemed to be the necessary and pivotal element for policing and prosecuting insider trading in Japan.<sup>44</sup> By 1994, however, the SESC had launched only two investigations of insider trading, and had only procured one conviction.<sup>45</sup> It was not until July 1997 that an investigation by the SESC ended in a prison term for insider trading.<sup>46</sup>

The recent changes in Japanese law may seem to bring it more in line with American law, but the provisions do not punish insider trading nearly as severely as in the United States. The United States Insider Trading and Enforcement Act of 1988 provides for a penalty of up to ten years imprisonment,<sup>47</sup> compared to six months in Japan. More importantly, Japan has rarely invoked any punishment for violations of Article 190-2 or 190-3<sup>48</sup> and has only sentenced one person to a prison sentence to date.<sup>49</sup>

In sum, Japan is not nearly as willing to subject inside traders to strict criminal punishments as the United States. If the presence of enforced criminal provisions is an indication of the perceived immorality of a particular act, the varying treatments suggest that Americans view insider trading as extremely underhanded while the Japanese find the practice less objectionable.

This reaction is related more to circumstances than differing moral convictions. I will argue below that, in fact, insider trading in the United States may really be more underhanded than trading on inside information in Japan.

## *2. The Ubiquity of Insider Trading in Japan Despite Legal Prohibitions*

The comparative dearth of criminal insider trading sanctions in Japan would not be notable if substantially less insider trading occurred in Japan. However, just the opposite is true. Japan is known by foreign critics as an "insider's heaven"<sup>50</sup> where people rampantly profit from inside information with little detection or prosecution.

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40. See Parker, *supra* note 4, at 1399.

41. See *id.* (citing Shokentorihiki tono Kosei o Kakuhosuru Tame no Shokentorihikiho tono Ichibu o Kaiseisuru Horitsu [Law to Partially amend the Securities and Exchange Law and Other Laws to Ensure the Fairness of Securities and Other Transactions] and Law No. 73 of 1992 [Securities Fairness Law] (Japan)).

42. See *id.* at 1400.

43. See *id.* at 1400 n.9.

44. See *id.* at 1417.

45. See *id.* at 1400 n.10.

46. See JAPAN WEEKLY MONITOR, *supra* note 4.

47. See 15 U.S.C. § 78ff(a) (1994).

48. See Stanley S. Arkin, *What Other Nations Can Teach Us About Criminal Justice*, N.Y. L.J., Feb. 13, 1997, at 3.

49. See JAPAN WEEKLY MONITOR, *supra* note 4.

50. Akashi, *supra* note 18, at 1302 n.45 (quoting a University of Tokyo law professor).

Commentators have long recognized that inside information is offered and used on a regular basis in Japan. David Sanger, a New York Times reporter, has come across many anonymous sources attesting to the frequency of Japanese insider trading.<sup>51</sup> He observed that "[b]uying and selling shares based on inside information is a time honored tradition to cement relationships between brokers and their biggest clients."<sup>52</sup> Larry Zoglin, an American attorney, noted that "the cultivation of close ties to sources of information . . . has long been considered an important service offered by Japanese brokerage firms."<sup>53</sup> Another commentator described Japan as a place where "[b]ankers, brokers, favoured customers and large shareholders have always had privileged access to corporate information in a country where long term business relationships are the key to profits."<sup>54</sup> Insider trading has become so ordinary in Japan that a highly regarded foreign fund manager recently defended his involvement in such activities, claiming, "it's not insider trading. It's trading on privileged information."<sup>55</sup>

There is also more concrete evidence of insider trading. In August 1987, Tatecho Chemical Industries, a Japanese company, had to be rescued by its bankers after incurring massive losses in the Japanese bond futures market. Hashin Sogo Bank, one of Tatecho's financiers, sold 337,000 Tatecho shares the day before Tatecho announced its losses. Nevertheless, with the 1988 amendments to the SEL not yet enacted, Japanese authorities could find no specific evidence of a legal violation under which to prosecute the bank.<sup>56</sup> Both domestic citizens and the foreign press criticized Japanese authorities for their lack of action.<sup>57</sup>

Despite the presence of the new SESC and a few convictions, insider trading is still common in Japan today. An anonymous Japanese broker at a top foreign brokerage house told a reporter investigating insider trading in Japan that insider trading "goes on all the time [and is] part of doing the job in Japan."<sup>58</sup> Japanese brokers report that "clear-cut illegal trading" is still an "everyday occurrence at most brokerages."<sup>59</sup> A general manager at Japan's Capital Markets Research Institute explained matter-of-factly, "At one time Japan was what you would call an inside-trading and share-price manipulation paradise. . . . While I don't think it is true that Japan is still such a paradise, in some way somebody is still sneaking through dubious or illegal trades."<sup>60</sup> One commentator observed that despite recent talk of increased enforcement of insider trading regulations, Japanese officials "never

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51. See David E. Sanger, *Insider Trading, the Japanese Way*, N.Y. TIMES, Aug. 10, 1988, at D1.

52. *Id.*

53. Zoglin, *supra* note 8, at 421.

54. Nigel Holloway, *Squeezing the Manipulators*, FAR E. ECON. REV., Sept. 15, 1988, at 92.

55. Velisarios Kattoulas, *Insider Trades in Japan Leaves Persistent Stain On the System*, INT'L HERALD TRIBUNE, Feb. 25, 1997, at 1.

56. See *id.*

57. See Akashi, *supra* note 18, at 1302 & nn.44 & 45. This mild outcry by Japanese citizens shows they certainly have some distaste for insider trading, even if their aversion is not as strong as that of Americans.

58. Kattoulas, *supra* note 55, at 1.

59. *Id.*

60. *Id.*



strenuously acted upon these regulations in the first place, the deterrent effect of the amendments [is] questionable[,] and enthusiasm [is] somewhat limited."<sup>61</sup>

Perhaps the best example of how commonplace insider trading is in Japan is anecdotal. Velisarios Kattoulas reported the following after his trip to Japan in 1997:

Sitting at the counter of a tiny sushi bar, the Japanese stockbroker swirled his beer nervously and lowered his voice as he explained his knack for insider trading.

"I used to be an analyst visiting companies and writing reports about them, so I know a lot of senior people at top companies," said the middle-aged broker, who asked not to be identified.

To illustrate this point, he recommended shares in a large company with which he had ties. In three days, he said, the company would announce earnings far better than expected.

Three days later, he was right. The company's share price soared.<sup>62</sup>

Though the offender in question did lower his voice and ask not to be identified, the existence of those like him is known all too well by Japanese citizens. Kattoulas observed that if one was to "tell [the] tale of inside information to anybody familiar with trading stocks in Japan," they would simply "nod knowingly."<sup>63</sup>

In sum, even though there are laws prohibiting insider trading, the practice seems to flourish in Japan. Recent legal changes have increased detection and prosecution somewhat, but mostly the lack of enforced legal sanctions is consistent with the observation that the Japanese do not have as strong a repulsion to insider trading as Americans.<sup>64</sup> One observer commented that "[a]lthough insider trading is generally condemned in the United States, and although United States cases imposing civil liability for such trading have drawn attention in Japanese business circles, most Japanese do not believe that insider trading is immoral."<sup>65</sup>

But why is the view of insider trading different in the United States than in Japan? If insider trading is immoral, is it not immoral in any setting? Parts III and IV of this article will explain why Americans have found trading on inside information so odious, while pointing out differences in Japanese markets that make insider dealings less objectionable in that country.

### *C. Insider Trading in Canada*

A similar, though less extreme, tale can be told about how legal prohibitions against insider trading evolved in Canada and were largely ignored by Canadian officials.

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61. Parker, *supra* note 4, at 1410.

62. Kattoulas, *supra* note 55, at 1.

63. *Id.*

64. For an argument against this conclusion see *supra* note 4.

65. Misao Tatsuta, *Proxy Regulations, Tender Offers, and Insider Trading, in JAPANESE SECURITIES*, *supra* note 3, at 159, 191-92.

### 1. Legal Prohibitions

Though it lacks the intensity of the United States, Canada has done more to enforce insider trading laws than most countries. Robert White, a professor at a Canadian business school, observed that Canada has the second strongest enforcement record worldwide of insider trading laws.<sup>66</sup> Unlike in the United States and Japan, Canada has no single federal law governing insider trading. Instead, individual provinces have their own insider trading prohibitions.<sup>67</sup> This article focuses on the laws of Ontario because it is acknowledged to be the principle Canadian market and the regulations of other provinces are largely harmonized with the laws of Ontario.<sup>68</sup>

Canada's laws against insider trading are not much different than the laws of other countries. An Ontario statute provides:

No person or company in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed.<sup>69</sup>

Just as in the United States, the provision also prohibits insiders from tipping others about important undisclosed business information that could be used to make trading profits.<sup>70</sup>

Legislation against insider trading was first introduced in Ontario in 1966. The legislation used United States law as a model, but did not invoke any criminal penalties — only civil liability and administrative sanctions.<sup>71</sup> By 1980, however, the statute was amended to make insider trading a criminal offense punishable by "a fine not more than [Can]\$2000 or [by] imprisonment for a term of not more than one year."<sup>72</sup>

Despite this stricter penalty, prosecution of insider trading remains minimal. An attorney at the Ontario Security Commission noted that "there have hardly been any insider trading cases prosecuted in Canada."<sup>73</sup> When people were prosecuted, they were given little more than a slap on the wrist. In 1983, Come Carbonneau, an insider at Falconbridge Copper Corporation, bought 2000 shares of his own

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66. See Valerie Lawton, *Bennett Case Highlights Regulators' Dilemma*, GLOBE & MAIL, Sept. 4, 1996, at B14.

67. See Michael D. Mann & Lise A. Lustgarten, *Internationalization Of Insider Trading Enforcement: A Guide To Regulation and Cooperation*, 798 PLI/CORP 7, 48 (1993).

68. See Cally Jordan, *Regulation of Canadian Capital Markets in the 1990s: The United States in the Driver's Seat*, 4 PAC. RIM L. & POL'Y J. 577, 579-80 (1995). As of 1994, 81.8% of all equity trading in Canada occurred on the Toronto Stock Exchange. See *id.* at 583 n.22.

69. Securities Act, R.S.O., ch. 5.5, § 76 (1990) (Can.).

70. See *id.*

71. See Rosenbaum, *supra* note 5, at 485-86.

72. Securities Act, R.S.O., ch. 466, §§ 75, 118 (1980) (Can.); see also Rosenbaum, *supra* note 5, at 486.

73. Leonard Zehr, *Sources Say Ontario Inquiry Touches Most Canadian Security Firms*, WALL ST. J., July 7, 1987, at 4.

corporation from his stockholders shortly before the company released information about favorable drilling results. Mr. Carbonneau was prosecuted by the Ontario Security Commission and found guilty, but his punishment was only a fine of Can\$250.<sup>74</sup>

Shortly after widescale publicity of insider trading prosecutions in the United States, Canada again increased the penalty for insider trading substantially.<sup>75</sup> In 1987, the Ontario parliament raised the maximum penalty to "not more than [Can]\$1,000,000 or to imprisonment for a term of not more than two years, or to both."<sup>76</sup> In the early nineties, at least one Ontario Security Commission attorney spent six months in Washington, D.C. to investigate the way the United States Securities and Exchange Commission handles insider trading.<sup>77</sup>

## 2. *The Lukewarm to "Pretty Warm" Reception of Insider Trading Laws in Canada*

There has been a greater degree — but not a great degree — of enforcement of insider trading prohibitions in Canada in recent years. There have been a few high profile investigations, and even a few prosecutions that have included large financial penalties. Former Liberal cabinet minister and prominent Winnipeg businessman James Richardson was fined Can\$550,000 for insider trading that took place in 1989.<sup>78</sup> In a 1993 case, a large trucking company that was under investigation for insider trading paid the Ontario Securities Commission Can\$23 million to settle their case.<sup>79</sup> Though this is quite a stark change from the Can\$250 fines of the early eighties, these large fines still occur only rarely,<sup>80</sup> and only one person has ever been jailed for insider trading in Canada.<sup>81</sup>

Of course, the lack of prosecutions and prison sentences would not reflect ambivalence if insider trading rarely occurred in Canada. However, the practice is far from rare. One investigation of possible insider bond trading that did not lead to formal charges left one trader feeling like the incident was "quietly swept under the rug."<sup>82</sup> He suspected that "[i]f this had happened in the United States, the Federal Reserve Board and the Securities and Exchange Commission would have put these guys out of business."<sup>83</sup> Ed Waitzer, a former chairman of the Ontario Securities Commission, noted that while inside traders "may not be making out like bandits, at the margin, you can be sure it's going on."<sup>84</sup> In 1997, an anonymous

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74. See *id.*; Stanley M. Beck, *Of Sectarians, Analysts, and Printers: Some Reflections On Insider Trading*, 8 CAN BUS. L.J. 385, 409 n.98 (1983-84).

75. See Zehr, *supra* note 73.

76. Securities Act, R.S.O., ch. 466, §§ 75, 122 (1990) (Can.).

77. See Doug Kelly, *OSC Beefs Up Insider Trading Probes*, FIN. TIMES, Apr. 30, 1993, at 1.

78. See Jade Hemeon, *Insider Trading Tough to Police*, TORONTO STAR, Feb. 25, 1997, at D1.

79. See *id.*

80. See *id.*

81. See Haggert, *supra* note 6, at 2.

82. Lisa Grogan-Green, *Bond "Whitewash" On Bay Street?: Ottawa Review of "Insider" Case Leaves Questions*, FIN. POST, Dec. 18, 1993, at 5.

83. *Id.*

84. Hemeon, *supra* note 78, at D1.

securities lawyer commented that "[i]nsider trading is absolutely enormous . . . It's as common as cheating on income tax."<sup>85</sup>

Nonetheless, investigating and prosecuting insider trading has not been a high priority in Ontario. Funding for the Ontario Securities Commission has dwindled substantially, and former Chairman Waitzer complained that the Commission is severely underfunded to deal with the insider trading problem.<sup>86</sup> The *Toronto Star* reported the situation in 1997 as follows:

Three years ago, the OSC had 140 ongoing investigations of all types, including insider trading. Currently there are only 74. The number of professional investigation staff has dropped to 12 from 29 due to lack of money.

Unless a case is a blatant priority, it tends to sit in the waiting room, officials say.<sup>87</sup>

Larry Waite, the director of enforcement for the Commission, complained that the lack of enforcement was not consistent with strong opposition to insider trading. He observed, "It's a matter of throwing more resources into the problem, and bringing out more cases. . . . Are we setting a strong deterrent? No. We've got to bring more cases and win more."<sup>88</sup> Mr. Waite seems aghast at the injustice of allowing insider trading to continue to go unpunished. Nevertheless, the lack of funds from Ontario's legislature suggests most Canadians are not nearly as disturbed by insider trading.

Still, Mr. Waite is not a lone dissenting voice. The recent large financial penalties, as well as continuing OSC investigations show that Canadians do have a greater opposition to insider trading than the Japanese, even if their moral outrage does not rise to the level of Americans'. A Canadian judge referred to an inside trader as a "rapacious thief."<sup>89</sup> The one person who was imprisoned for insider trading in Canada was said to have been "[d]isgrace[d] . . . in the business community."<sup>90</sup> Joe Groia, of the Ontario Securities Commission, called insider trading "unacceptable because it is unfair."<sup>91</sup> One Canadian newspaper showed obvious disdain for inside traders in its following account of the practice:

It's [sic] perpetrators are usually people of power and position who have access to inner corporate circles. They often operate in the rarified air of office skyscrapers and the main tool of their trade is the telephone.

They almost never meet their victims, who often live miles or even continents away. Some victims don't even know they've been duped.<sup>92</sup>

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85. *Id.*

86. *See id.*

87. *Id.*

88. *Id.*

89. *Woods v. The Queen*, No. B24/93, 1994 Ont. C.J. LEXIS 2002, at \*90 (Ont. Ct., Gen. Div. 1994) (Can.).

90. *Id.* at \*87.

91. Larry Welsh, *It's the Stock Cops*, *TORONTO STAR*, Mar. 5, 1989, at F1.

92. David Baines, *When Insiders Cheat*, *VANCOUVER SUN*, Feb. 4, 1989, at H1.

Indeed, in a survey of Canadian investment firms, fourteen of fifteen firms felt that insider trading "gave an unfair advantage to a few individuals which operated to the detriment of the majority of investors."<sup>93</sup>

Canada's maximum insider trading penalty of two years in prison is eighteen months longer than Japan's.<sup>94</sup> This seems to confirm that Canadians view insider trading as a greater wrong than the Japanese. However, the disparity may not be what it appears. Only one person has ever been put in prison for insider trading in Canada, and he was only sentenced to ninety days in jail.<sup>95</sup> In fact, even the ninety days was a difficult sentence to obtain. The trial court in the case refused to follow the advice of the Ontario Securities Commission and would not sentence the offender to any time in prison. The prison sentence was obtained only after an appeal to a higher court.<sup>96</sup> Still, Canadians seem a little more willing to punish people for insider trading than the Japanese, even if they are unwilling to impose long prison sentences.

In sum, both Canada and Japan have passed criminal prohibitions against insider trading following the example of the United States, but neither nation has as tough a statutory scheme as the United States, and neither nation has been willing to prosecute their citizens to the full extent of the law. In Japan, it is questionable whether officials object to insider trading at all.

### *III. The (Im)Moral Dimension of Insider Trading*

The fact that insider trading is not punished in other countries leads one to wonder why insider trading is prohibited in the United States. I will argue below that United States lawmakers consider the practice to be immoral, a view that seems to be shared by the United States Supreme Court. Most academic proponents and opponents of banning insider trading — while making important points about the economic consequences of insider trading — fail to address the implications of the Supreme Court's determination that insider trading is immoral. From this important moral perspective, the appropriate method for determining if insider trading should be prohibited in a particular country involves assessing whether the practice is viewed as immoral in that country given the structure of the country's securities market.

#### *A. Insider Trading Is Prohibited in the United States Because United States Lawmakers Have Deemed the Practice Immoral*

The fact that people go to jail for insider trading shows that a primary reason that the practice is outlawed is because it is considered immoral. Those proven to have

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93. Rosenbaum, *supra* note 5, at 493.

94. See Securities Act, R.S.O., ch. 466, §§ 75, 122 (1990) (Can.).

95. See Haggert, *supra* note 6, at 2.

96. See *Woods*, 1994 Ont. C.J. LEXIS 2002 at \*93. The appellate judge felt that the "breach of public trust by Woods using insider information obtained through his special relationship with PETCO to . . . the disadvantage of the participants in the stock markets dictates a more severe penalty in the circumstances than the trial judge imposed." *Id.* at \*92-\*93.

violated insider trading laws in the United States face severe criminal punishment. In perhaps the most famous American case, Ivan Boesky, a wealthy businessman, accumulated \$80 million from illegally trading on inside information he received from an investment banker.<sup>97</sup> Boesky had to give the money back, was sentenced to three years in prison, and forced to pay a \$250,000 fine.<sup>98</sup>

The imposition of criminal sentences for insider trading sets the practice apart from typical corporate law prohibitions. American corporate law, for example, requires that insiders refrain from hiring family members if the decision is not clearly in the best interests of the corporation,<sup>99</sup> refrain from altering the trading rights of the current stockholders without their approval,<sup>100</sup> and refrain from selling control of the corporation to a person likely to loot the corporation of all its assets.<sup>101</sup> But if insiders violate these prohibitions, they are forced only to compensate those harmed by the decision. If the same insiders sell stocks when they have inside information, they could be imprisoned and thus given what one philosopher has called "a brand of censure and condemnation that leaves one, in effect, in permanent disgrace."<sup>102</sup>

Censure and condemnation go hand in hand with imprisonment because people are justly put in jail only when they have committed immoral acts. Those who commit immoral acts are thought to deserve punishment for their offenses. There is no injustice when a cold-blooded murderer has to spend a portion of his life behind bars. But if a person is condemned and denied most of her rights only for some external goal of society, a grave injustice is thought to have occurred. Criminal law theorists often point to the example of an innocent person that a judge decides to punish because an angry mob of citizens is prepared to create violence if the man went free. It may bode well for the safety of all involved to punish the innocent offender, but the judge acts unjustly if she punishes the innocent because she thereby violates the rights of that individual.

This injustice extends to any case in which the government is willing to sentence one to imprisonment when the person does not deserve such a sentence by virtue of committing an immoral act. The government may have a goal of deterring people from failing to take advantage of new trading technologies or pouring scarce resources into business ventures that are sure to fail. But most would agree that the government would be acting unjustly if the state passed a law subjecting those engaged in merely inefficient conduct to three years in jail.<sup>103</sup> Ivan Boesky was

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97. See James Sterngold, *Boesky Sentenced to 3 years in Jail in Insider Scandal*, N.Y. TIMES, Dec. 19, 1987, at 39.

98. See *id.* at A1; see also SEC v. Boesky, No. 11288, 1986 WL 15283 (S.D.N.Y. Nov. 14, 1986); Welsh, *supra* note 91, at F1.

99. See *Bayer v. Beran*, 49 N.Y.S.2d 2 (N.Y. Sup. Ct. 1944).

100. See *Telvest v. Olson*, No. Civ.A.5798, 1979 WL 1759, at \*4 (Del. Ch. Mar. 8, 1979).

101. See *Debaun v. First W. Bank & Trust Co.*, 120 Cal. Rptr. 354 (Cal. Ct. App. 1975).

102. 1 JOEL FEINBERG, *THE MORAL LIMITS OF THE CRIMINAL LAW* 24 (1984).

103. One may contend that the inefficiency surrounding insider trading is worse than other inefficient conduct because insider trading has wide-scale harms and inside traders benefit from the practice. Though initially appealing, the objection does not undercut the claim that immorality is a

put in jail because the United States government has deemed insider trading immoral and worthy of punishment.

Just as it is an injustice when an innocent man is punished, there is also an injustice when a guilty man goes free. United States lawmakers have determined that insider trading is immoral, and that determination presumptively requires that those who engage in insider trading be punished. Anyone arguing for or against prohibitions of insider trading must begin by determining whether the practice is immoral.

### *B. The United States Theory of the Immorality of Insider Trading*

Drawing on principles of fraud, the United States Supreme Court offered a theory to explain why trading on inside information is a deceptive practice that deserves punishment. As discussed above, it is intuitive that certain immoral acts should result in punishment of the offenders. Perhaps making profits through inside information does not immediately strike one as an act of unadulterated evil. A murderer or a common thief has acted wrongly, and few theorists of any stripe could convince us that it would be improper to punish these evildoers. Insider trading presents a more complex problem. A savvy trader is expected to collect as much information as possible when making trades.<sup>104</sup> Markets encourage the trader to have extensive information about the securities she trades. The trader will be successful if she uses her informational advantage to obtain large profits.<sup>105</sup> Yet if the trader is operating on information obtained in the course of employment with the corporation at issue (or was tipped about such information from someone else working with the corporation), her use of the informational advantage is considered unfair, illegal, and immoral. Although it is a trader's goal to have better information than anyone else in the market, when the information is obtained by virtue of being a corporate insider, American law treats the trader as a criminal. The theoretical basis for this disparate treatment provides insight into why certain trading activities may have different moral implications in the United States than in other countries.

When making moral assessments of questionable activities, it is important to draw comparisons to situations in which we are more certain of the deviousness of the conduct. For example, it seems wrong to sell someone a car while never mentioning the fact that it has no engine. This situation seems quite analogous to when Hashkin Sogo Bank sold 337,000 shares of Tatecho Industries while failing to mention that

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necessary component of punishable behavior. Consider an unusual hypothetical. Instead of engaging in inside deals, Ivan Boesky can be imagined to buy most of the world's neon to pursue his life long dream — to build a massive neon fun park — though he is nearly certain the pursuit will be an economic failure. Boesky will have gained incredible utility from the pursuit while many businesses that depend on neon may fail. Boesky will have acted inefficiently, benefitted immensely, and harmed the market. I suspect that though we may find grounds for pursuing Boesky in tort litigation, we would balk at the prospect of putting Boesky in prison for pursuing his dream because he knew full well that he was acting inefficiently.

104. See LEO KATZ, *ILL-GOTTEN GAINS: EVASION, BLACKMAIL, FRAUD AND KINDRED PUZZLES OF THE LAW* 172 (1996) [hereinafter KATZ, *ILL-GOTTEN GAINS*].

105. See *id.*

Tatecho was set to announce huge losses on the next day.<sup>106</sup> But the analogy is not as strong as it first appears. While you would certainly expect a car to have an engine, it is less clear that you have the right to expect a stock will not lose great value on the next day. In fact, it is just this risk that makes trading in stocks so profitable. Further examination is necessary to see if the two scenarios can be considered analogous.

There is little doubt that the sneaky car salesman warrants punishment and would likely be found guilty of fraud. Our moral convictions about this case are reflected in the American criminal law which generally outlaws transactions where a person "fails to correct a false impression which the deceiver previously created or reinforced."<sup>107</sup> Even though the offender did not explicitly claim the car had an engine, she still misled the buyer. A seminal treatise on fraud noted that to

constitute a fraudulent misrepresentation, it is not necessary that statements should be made in terms expressly affirming the existence of some untrue fact. If the alleged misrepresentation be made by one party in such terms as would naturally lead the other party to suppose the existence of such state of facts, and if it be so made designedly and fraudulently, it is as much a fraudulent misrepresentation as if the statement of untrue facts was made in express terms.<sup>108</sup>

The hypothetical car salesman likely created and reinforced a false impression when she sold the engineless car at a typical car price.

The United States Supreme Court has found insider trading to be illegal by drawing analogies to fraud. Justice Powell noted that Rule 10b-5, the rule used to prosecute inside traders, is "a catchall provision, but what it catches must be fraud."<sup>109</sup> However, one is not considered fraudulent simply by failing to disclose all known facts about a security. For example, a trader may have good reason to believe (say, because of an econometric study of past trends) that developing technologies in mass transit will likely lead to a decrease in the value of General Motors stocks. Yet, when the trader sold her stocks, no one would argue that the trader culpably created a false impression because she did not reveal her information about the transit industry to those that purchased the stocks.

The distinction between the car salesman and the inside trader seems to rest on what we should expect a party in a transaction to disclose. While we should rely on the fact that a car salesman would tell us her bluebook-priced car had no motor, we would not be morally outraged if a trader of General Motors stocks did not tell us about all the findings of her research on trends in mass transit. Justice Powell distinguished insider trading by explaining that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when

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106. See *supra* Part II.B.

107. MODEL PENAL CODE § 233.3(3) (1985).

108. MELVILLE BIGELOW, *THE LAW OF FRAUD* 5 (Fred B. Rothman & Co. 1981) (1877).

109. *Chiarella v. United States*, 445 U.S. 222, 235 (1980).



he is under a duty to do so."<sup>110</sup> Legally and morally, such a duty to disclose will arise if the other party "is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."<sup>111</sup> Justice Powell pointed out a certain way in which the omissions of offenders can run afoul of our expectations. Not only can the type of information that is omitted trigger a violation of our expectations, but the identity of the party we are dealing with may also be the trigger that makes an omission violate our expectations. For example, the fact that a car has no motor will probably be a fraudulent omission no matter who is selling the car. The fraud is triggered by the type of information omitted. But whether or not a car is a terrible gas guzzler will likely only be a fraudulent omission if it is made by someone you have hired and paid handsomely to buy you a car that meets your exact specifications which include that the car be an efficient model. The identities of the parties to the transaction may therefore dictate whether the transaction is fraudulent.

Thus, Justice Powell states that the existence of the fiduciary relationship changes what we rightly expect from the other party in a business transaction. His theory of insider trading tracks our intuitions about fraudulent transactions. If a seller of General Motors stock is actually a director at General Motors, and knows specifically that the company will announce an unmatched technological breakthrough the next day, the stockholders would expect the trader-director, because of his fiduciary duty, to reveal this information before buying their stocks. When an insider who is engaged in trading does have information she received through the course of her work with a corporation, the United States Supreme Court has held that "the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation."<sup>112</sup> There is "a relationship of trust and confidence between the shareholders of a corporation and those shareholders who have obtained confidential information by reason of their position with that corporation."<sup>113</sup> Therefore, just as we would rely on being told if a car had no motor, we would rely on being told if the buyer of our stocks was a corporate official who knew our stocks would go through the roof the next day. Corporate officials have a fiduciary duty to disclose such information to the shareholders of their corporation. If they complete a transaction with an unknowing shareholder, it follows that they have acted fraudulently and immorally.

An official in a company would clearly owe her shareholders a fiduciary duty and should not hide her information. This duty seems less pronounced, however, when the hypothetical General Motors inside trader sells stock to someone outside the corporation. Nevertheless, in *In re Cady, Roberts & Co.*, the Securities and Exchange Commission recognized such a sale by a corporate insider to an unknowing party to a transaction who is in the process of becoming a shareholder

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110. *Id.* at 228.

111. *Id.*

112. *Id.* at 227.

113. *Id.* at 228.

in the insider's corporation would carry with it similar fiduciary duties.<sup>114</sup> The commission embraced the reasoning of Judge Learned Hand who remarked that

The director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one.<sup>115</sup>

Just as one holds a fiduciary duty to the less informed shareholders in her company, she owes the same duty to those whom she attempts to make shareholders in her company. Withholding inside information in such transactions would be fraudulent.<sup>116</sup>

Thus, insider trading is prohibited in the United States for the same reason murder or theft is prohibited — it is thought to be immoral.

114. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912-14 (1961).

115. *Id.* at 914 n.23 (quoting *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951)). The Supreme Court approved this reasoning in *Chiarella*, 445 U.S. at 227 n.8.

116. Hundreds more hypothetical cases of trading with "inside" information could be examined under this "fiduciary duty" theory and not all would lead to liability using fraud principles. For example, the holding in *Chiarella* found no liability for an unaffiliated financial printer who traded with inside information he got from handling announcements of corporate takeover bids because *Chiarella* had "no affirmative duty to disclose the information as to the plans of the acquiring companies." *Chiarella*, 445 U.S. at 223, 224-25.

Nonetheless, the clearest cases of insider trading seem to be objectionable when drawing on principles of fiduciary duties, making this strategy the most telling for the purposes of analyzing moral convictions about insider trading. However, scholars and jurists alike have certainly found other moral grounds for opposing insider trading. Most notably, the misappropriation theory argues that insider trading is unethical because

[i]nformation may count as property possessed by a firm which is entrusted to employees and contractors under the condition that [it] be used only for corporate purposes. Any use of this information for personal gain, whether by agents of the firm or confidantes of such agents, or even thieves, should count as fraud.

Scheppele, *supra* note 2, at 140. The Second Circuit has applied this theory since the early eighties. See, e.g., *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). The Supreme Court applied the misappropriation theory for the first time only recently. See *United States v. O'Hagen*, 521 U.S. 642 (1997). As a result, it seems likely that *Chiarella* would be decided differently if it came before the Supreme Court today, since the printer can certainly be described as having misappropriated information that belonged to the firm.

For less accepted accounts of why insider trading is immoral, see Scheppele, *supra* note 2, at 150-72 (arguing that insider trading should be outlawed because individuals would not choose a world in which insider trading was allowed if they had to decide if it was permitted before they knew if they would be an insider or an outsider) and KATZ, *ILL-GOTTEN GAINS*, *supra* note 104, at 171-89 (arguing that consenting to a corporate policy that allows insider trading is akin to consenting to enslavement or torture in that the practice must be prohibited even if the victim consents to it).

*C. Academic Discussion About Insider Trading Largely Misses Moral Implications of the Practice*

Given the United States Supreme Court determined that insider trading is prohibited because it is immoral,<sup>117</sup> one would expect academic discussion of the issue to center on morality, particularly whether the practice is immoral or whether the immorality of a practice is sufficient reason to prohibit insider trading. However, both proponents and opponents of insider trading prohibitions have focused primarily on the economic consequences of the practice. Below, I will examine various schools of thought regarding insider trading with an analysis of each in light of the moral implications of trading on inside information.

*1. The Claim that Insider Trading Increases Market Efficiencies*

Some believe that the prohibition of insider trading is justified because the prohibition will allow economic gains in the markets in which the prohibition is enacted. One theorist noted that "regulation helps ensure a fair and efficient market in which investors may invest more securely, without fear of fraud or other market abuses."<sup>118</sup> Another commentator offered, "Countries with lax regulation will be seen as a modern day Barbary Coast to which some investors will be unwilling to launch their investment."<sup>119</sup> Insider trading may also be inefficient because it creates an incentive for insiders to delay the release of important information until they have had the chance to trade on it.<sup>120</sup> Alternatively, inefficiencies can arise when insiders purposely make poor decisions in hopes of making trading profits from the advanced information that the company's financial outlook will make a sudden down turn.<sup>121</sup>

This mode of argument does little to justify criminalization of insider trading. As discussed above, the fact that a practice will lead to economic gains is not reason enough to put those who engage in the practice in jail. Easterbrook and Fischel's treatise on corporate law ignores this fact when considering the possibility of imprisonment for insider trading. They argue:

If the probability of detecting improper trades is low, public enforcement may be best. When detection is rare, the penalty must be increased to create deterrence. When detection is highly unlikely, the optimal fine can exceed the net wealth of the offender. Thus public

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117. Justice Powell uses the word "unfair," not "immoral." *Chiarella*, 445 U.S. at 227. But because his theory is not based on the economic advantages or any further consequences of the prohibition, he seems to be invoking a moral social norm by using the word "unfair," making the words "immoral" and "unfair" interchangeable as he uses them.

118. Parker, *supra* note 4, at 1399.

119. James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 HASTINGS INT'L & COMP. L. REV. 149, 157 (1993).

120. See KATZ, *ILL-GOTTEN GAINS*, *supra* note 104, at 172.

121. See MACEY, *ECONOMICS*, *supra* note 10, at 34.

enforcement, which can lead to imprisonment and other penalties firms cannot adopt for themselves, may be efficient.<sup>122</sup>

Easterbrook and Fischel's claim ignores the injustice in exacting large sentences in the mere interests of efficiency. Littering is also hard to detect and would likely be deterred much more effectively if it carried a three-year prison sentence. But if Easterbrook or Fischel were cuffed and driven to the "big house" after they littered, they likely would object to the imposition. Their objection probably would not be set to rest if they explored the legislative history of the harsh anti-littering penalty and found it supported by a rigorous econometric model that determined "the most littering would be deterred while using the least resources" if the penalty upon detection of littering was exactly a three-year prison term. No matter how economically advantageous it would be to live in a litter-free environment, the government does not have the option of doling out long jail sentences for littering because littering is a fairly tame crime, and people do not deserve to have most of their rights taken away as a result of that crime.<sup>123</sup> Similarly, any argument that insider trading should be criminalized cannot be based solely on the efficiency of prohibiting the practice.

## 2. *The Claim that Prohibiting Insider Trading Decreases Market Efficiency*

Academics often argue for the removal of the prohibition against insider trading on efficiency grounds. The argument usually explains all the economic advantages of allowing people to trade on inside information and concludes that the practice should be legal. Professor Leo Katz has summarized the economic benefits associated with insider trading as follows:

Allowing insiders to trade on their special knowledge can function as an effective form of incentive compensation. That's only the most obvious benefit. Another one arises from the fact that once insiders start to trade on their special information, they will gradually cause the stock price to rise, and thus can subtly let the market know about economically significant developments without actually having to announce what they are. This is important if making an outright announcement of the discovery would spoil its value to the company, as would happen if the company announced its finding of oil before it had actually been able to buy up all the land on which the oil field is located.<sup>124</sup>

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122. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 263 (1991).

123. Fans of folk music may recall when Arlo Guthrie sang his true story about being put in jail for littering. Officer Obie put Guthrie in a cell and asked him to hand over his belt and his wallet. The song went:

And I said "Obie, I can understand you wanting my wallet so I don't have any money to spend in the cell, but what do you want my belt for?" And he said "Kid, we don't want any hangings." And I said, "Obie, did you think I was going to hang myself for littering?"

Arlo Guthrie, *Alice's Restaurant Massacre*, on ALICE'S RESTAURANT (Reprise Records 1967).

124. KATZ, *ILL-GOTTEN GAINS*, *supra* note 104, at 72.

Of course, just because a practice has economic advantages does not mean that it should be legal. Allowing crimes such as murder and rape to go unpunished because the practices yielded economic advantages would be unjust.<sup>125</sup> Similarly, if insider trading is immoral, it does not seem just to remove the prohibition of insider trading simply because the practice can yield economic advantages.

But an inside trader is no murderer. And though a world where murders and rapes are not censored by the state is troubling, a world where insider trading goes unpunished is far from revolting. An advocate of lifting the prohibition may point out that there are plenty of immoral activities, far short of murder, that we allow to go unpunished because there are state interests other than handing out just desserts. For example, adultery, deceptions in friendships, and failure to rescue someone who is drowning are all acts that are immoral but that are not punished because of some countervailing interest of government. An advocate of lifting the insider trading ban may say that even if there is some truth to the United States Supreme Court's claim that the practice is immoral, we should not punish the act because of our countervailing interest in the economic advantages of insider trading.

However, even if there are cases when we do not punish people who have acted immorally, it is not because it would put the state at an economic disadvantage to punish the person, it is because prohibiting that particular act would impermissibly violate the state-protected rights of the offender. For example, governments have hesitated to punish people who fail to rescue a person in peril — even when the rescue could save a person's life and would cause little inconvenience to the would-be rescuer — because it would be too great an imposition on our liberty to require us to help strangers.<sup>126</sup> Similarly, when we use words to hurt our friends or even strangers, we do not feel that it is the government's place to punish us. Freedom of speech includes being able to speak even when nearly everyone believes it would be morally bad to say such things under the circumstances. Laurence Tribe has noted that if "the [United States] Constitution forces government to allow people to march, speak, and write in favor of peace, brotherhood, and justice, then it must

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125. One can imagine an argument that imprisonment has grown very expensive, and as a result, so few people commit murder or rape that it would lead to net loss in resources to punish the few people who do commit the terrible acts. It is untenable that a rigorous economic study proving the truth of this argument would convince state officials to stop punishing murderers or rapists.

126. The fact that people are not punished for a "failure to act" (absent a pre-existing duty) is called the act requirement. Theorists often justify the act requirement as underpinned by concerns for liberty and the limits of government action. The most commonly cited explanation of why we cannot punish the immoral non-actor is the fear of a slippery slope. The fear is that if the government can require a casual bystander to save an imperiled baby simply because it would be moral to do so, the government could also require a rich man to give food to a starving beggar or require a surgeon to travel many miles because she is the only one who can perform a life-saving operation. See John Kleinig, *Good Samaritanism*, 5 PHIL. & PUB. AFF. 382 (1976). Notice that the ditch at the bottom of this slippery slope is an excessive government imposition on liberty. It is not that omissions are somehow immune from being considered severely immoral. Rather, some argue, government prohibitions of particular omissions could result in a situation where "there are so many people to help, the government would control how we spend most of our lives. [This would end] freedom and individuality." *Introduction to Chapter 7.3*, in THE PHILOSOPHY OF LAW 820 (Frederick Schauer & Walter Sinnott-Armstrong eds., 1996).

also require government to allow them to advocate hatred, racism, and even genocide."<sup>127</sup> Though individualized attacks on people can be akin to a "slap in the face" in which the "injury is instantaneous,"<sup>128</sup> our freedom of speech protects offenders from the punishment they would receive if they actually slapped someone in the face.

Thus, when one advocates removing the insider trading prohibition, one cannot simply argue that economic advantages would accrue. When the government fails to prohibit an immoral activity, it is never simply because economic advantages may stem from that activity. It is an injustice to let bad acts go unpunished unless such punishment would cause further injustice by violating the rights of offenders. There are no rights violated when people are prohibited from making inside trades.

Indeed, it is hard to think of a more highly regulated practice than securities trading. No one could argue that citizens have a right to buy and sell securities akin to the right to free speech or the right not to save an imperiled stranger.

### 3. *The Economic Retort to Moral Arguments*

Those basing their analysis of insider trading on economic costs and benefits may not be very moved by an account claiming that insider trading is immoral. Economists rightly worry that such claims are mostly vacuous. Professor Jonathan Macey claimed that if one provided some "intellectual content" to their concerns about insider trading, one would conclude that insider trading should not be prohibited because the prohibition is inefficient.<sup>129</sup> Judge (then a professor at the University of Chicago Law School) Frank Easterbrook noted that many "distinguished commentators" have stated that insider trading is "'manipulation,' 'fraught with sufficient possibility of abuse,' and 'unfair,' all without explaining why."<sup>130</sup> Easterbrook discerned that "[i]f arguments of fairness are to be more than discussion stoppers, they must have some content . . . Without some further explanation, however, we cannot tell how far these fairness principles reach."<sup>131</sup> Professor Macey even accused some who invoke what he calls "the fairness view" of "cynically attempting to further their own political goals at the expense of the integrity of the nation's security markets."<sup>132</sup>

The economists are correct that any view that a particular act is "just wrong" leaves something to be desired. Nonetheless, this does not mean that the claim that insider trading is immoral is an empty one. As discussed above, Justice Powell found insider trading to be "unfair" because it was akin to a particular type of fraud where a person in a business transaction fails to disclose a particular piece of

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127. LAURENCE TRIBE, *AMERICAN CONSTITUTIONAL LAW* § 12-8, at 838 n.17 (2d ed. 1988).

128. Charles R. Lawrence III, *If He Hollers Let Him Go: Regulating Racist Speech on Campus*, 1990 DUKE L.J. 431, 452 (1990).

129. MACEY, *ECONOMICS*, *supra* note 10, at 3, 13-16.

130. Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Principles, and the Production of Information*, 1981 SUP. CT. REV. 309, 324.

131. *Id.* at 323-24.

132. MACEY, *ECONOMICS*, *supra* note 10, at 3. I promise that this has not been the goal of this particular article.

information when the other party is "entitled to know" the information "because of a fiduciary or other similar relation of trust and confidence between them."<sup>133</sup> It is hard to shake the intuition that it is "just not right" to withhold certain kinds of important information from a person you have asked to hold you in special trust or confidence. For example, in his *Chiarella* opinion, Justice Powell cites a law review article<sup>134</sup> which considers the case of *Burroughs v. Wynn*.<sup>135</sup> Leslie Burroughs and Hilda Wynn were brother and sister. Burroughs owned a piece of land that was left to him by his mother. Burroughs was unable to support himself financially, and regularly received financial assistance from his siblings.<sup>136</sup> Hilda Wynn volunteered to pay the taxes on her brother's property and did so for many years. After fourteen years of enabling her brother to retain this land, Wynn devised a scheme to disappropriate her brother and take the land for herself. Wynn did not pay one of the annual tax payments, waited for the property to be sold at a tax collector's sale, and purchased the property for herself. Wynn "failed to mention" to her brother or her other siblings that she had not paid the tax on this particular occasion or that the land was going to be sold by the tax collector. In a civil case, the Supreme Court of New Hampshire found that Wynn's action constituted fraud against her brother.<sup>137</sup>

Hilda Wynn did not violate any express contract through her acts. She was certainly entitled to stop paying her brother's property tax, tell him of the end of her benevolence, and then buy the land at a tax sale if her brother could not pay. What the court objected to was the way Wynn used her position of trust and confidence as a means of gaining an advantage over the person she was helping. She "evidenced an intention to keep information of the sale from [Leslie's siblings] while exercising control over the property under the guise of protecting the interest of Leslie."<sup>138</sup> There seems little doubt that Wynn should not have done what she did. She entered into a relation of trust and confidence with her brother, then used her position of trust to make a profit at his expense. But the economic rationales for lifting the prohibition on insider trading also seem to apply to the *Wynn* case. Recall that insider trading is thought to be beneficial because if "insiders can trade on special knowledge they have concerning recently discovered oil fields, that might be an extra spur to discover such oil fields."<sup>139</sup> If people like Wynn can profit from forcing the sale of land, they will be much more likely to survey the land for

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133. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976). Justice Powell cited part of this provision in *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

134. See Fleming James, Jr. & Oscar S. Gray, *Misrepresentation — Part II*, 37 MD. L. REV. 488, 523-27 (1978).

135. 370 A.2d 642 (N.H. 1977).

136. See *Burroughs*, 370 A.2d at 643. The court stated, in passing, that Leslie Burroughs was handicapped. See *id.* But it is unclear if the handicap was physical or mental (or both). The decision does not turn on any "diminished capacity" of Burroughs; consequently, the existence of the handicap does not appear to have been relevant to the decision.

137. See *id.* at 644.

138. *Id.*

139. KATZ, ILL-GOTTEN GAINS, *supra* note 104, at 72.

oil fields, diamond mines, or profitability as a strip mall. Also, allowing an action like Wynn's would enable information about the economic potential of land to reach the market more quickly, since Wynn had an incentive to make widely known the discovered possibilities and profitability of the land.<sup>140</sup> Should the legal norm therefore be that one is permitted to enter into an agreement to help someone and exploit the position of trust for a profit? Of course not. Doing so in this case would be wrong. If a practice is wrong, and prohibiting the practice does not violate any important rights,<sup>141</sup> then the practice should be prohibited notwithstanding the economic benefits of the practice.

Once it is accepted that Hilda Wynn's scheme was immoral, one may analogize that insider trading is also immoral. Under Justice Powell's theory, an inside trader is someone who is placed in a position of trust and confidence and fails to disclose very relevant information to their stockholder in the course of a transaction. Just as it seems that Wynn should have told her brother she was going to stop paying the taxes and buy the land in a tax sale, the fact that the shares an insider is selling will be nearly worthless the next day should be disclosed if the insider is supposed to be acting in one's interests. Granted, Justice Powell's analogy is not conclusively reasoned or indisputable. But under a moral analysis, opponents must show that insider trading should not be prohibited because there are morally important differences between the Wynn case and insider trading cases. Instead, opponents of the insider trading prohibition have touted the economic benefits of taking advantage of a person one has been enlisted to help. Academic discussion about insider trading has failed to address Justice Powell's claims about what is wrong with insider trading.

The prohibition of insider trading on moral grounds is neither overly vacuous<sup>142</sup> nor undesirable. Justice Powell rightly finds insider trading to be subject to criminal prohibitions because it is akin to other fraudulent practices that we find immoral.

*D. The Question of Immorality Is Most Relevant to Whether Criminal Prohibitions Against Insider Trading Should Exist in Other Countries*

Economic arguments for and against insider trading are of great importance. If a country does determine that insider trading is not immoral, then the next question will be whether or not it would be efficient to ban the practice by allowing victims or securities commissions to bring civil suits against those who engage in the practice. Even though it is unjust to imprison someone merely to enforce an efficient ban on a practice, it would not be unjust to make people pay civil damages or repay the profits made if they contravene the ban. After all, we all expect to be somewhat coerced into compliance with societal norms and are willing to give up some personal interests if we violate these norms. We only object to the severity of being put in a cell and subject to societal condemnation based on a morally

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140. *See id.*

141. *See supra* notes 127-30 and accompanying text.

142. *See* Leo Katz, *Form and Substance in Law and Morality*, 66 U. CHI. L. REV. 556, 574-75 (1999) (arguing the vacuity of moral reasons are no more severe than the vacuity of economic reasons).



innocuous violation of social norms. Having to pay a fine is one thing, going to prison is another.

Many have argued that insider trading should be banned in Japan and Canada because of the economic advantages of a ban. Larry Zoglin, an American attorney, worried that because "of the size of the Japanese securities market, the disparity between Japanese and foreign enforcement of insider trading represents a significant challenge to the success of globalization of the world's securities market."<sup>143</sup> Similarly, a Canadian treatise on securities law concluded insider trading should be deterred "because it lessens the confidence of the investing public in the marketplace."<sup>144</sup> But it would be unjust for a country to try to bring about this efficient state of affairs by imposing criminal punishment on those who contravene insider trading laws, even if the nations find that they are unable to deter insiders without threatening long jail sentences.

And even if one agrees with Justice Powell that insider trading in the United States is immoral, that does not necessarily mean that all other countries should also ban the practice. Rudolph Giuliani was one of the chief prosecutors of American insider trading cases in the late eighties. He clearly found insider trading morally offensive. He showed disdain for inside traders when he remarked, "I've prosecuted all sorts of drug dealers and mafia chiefs and I've learned what makes them tick, . . . [b]ut I don't understand what motivates someone who already has \$100 million to try and make another \$20 million illegally."<sup>145</sup> On a 1987 visit to Montreal, Giuliani voiced disappointment that Canada did not have tougher laws against insider trading. He felt the current laws were "better than nothing," but that "longer prison terms would be more effective."<sup>146</sup> It seems that Giuliani is assuming that if insider trading is wrong in the United States it must be equally wrong anywhere else.

#### *IV. Insider Trading May Not Be as Wrong in Japan and Canada as It Is in the United States*

Below I will posit some possible reasons that insider trading is not as immoral in other nations as it is in the United States. In this, I attempt to make initial inroads into explaining why Japan, Canada, and virtually all other countries have not found insider trading to be overwhelmingly odious. In the parts that follow, I examine some of the elements of the relationship between corporate insiders and shareholders in Japan and Canada, and conclude that the nature of the relationship may be sufficiently different than in the United States, calling for a different set of moral duties owed by an insider to her shareholders.

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143. Zoglin, *supra* note 8, at 419.

144. MARK R. GILLEN, SECURITIES REGULATION IN CANADA 282 (1992) (citing an Attorney General's committee report).

145. *Canada's Insider Trading Laws Get Prosecutor's Lukewarm Nod*, TORONTO STAR, May 19, 1987, at B4.

146. *Id.*

*A. Insider Trading May Be Less Immoral in Other Countries Because the Relationship Between Insiders and Shareholders Is Less of a Relationship of Trust and Confidence*

Recall that Justice Powell's theory is based on the idea that insiders and shareholders are in a special relationship of trust and confidence. It seems possible that the relationship between insiders and stockholders has evolved differently in other countries than in the United States. When we examined Hilda Wynn, who secretly stopped paying her brother's taxes so she could take his land away,<sup>147</sup> it seemed clear that she had violated her duties in that particular relationship. She volunteered to help her brother and used her position of trust to make a profit at his expense. We can imagine a situation where Wynn was only a random landlord who seized on an opportunity to get Leslie Burroughs' land. Her scheme may have involved raising his rent when his taxes on a separate piece of property were due, knowing that Burroughs would end up overdrawn on his bank account and that his check for the tax would bounce. We would not abhor the landlord for her scheme to purchase the land through a tax sale because she would not owe a very high duty to Burroughs in this regard, even if the landlord-tenant relationship is somewhat one of trust and confidence. As a landlord, we would expect Wynn to warn Burroughs if the building was burning down, but she would not have a high moral duty not to take advantage of her knowledge of a tenant's minor financial troubles. Different relationships of trust and confidence require different duties.

The relationship between an insider in a corporation and shareholders has evolved to require many different types of duties in the United States.<sup>148</sup> But it is possible that differences in that relationship exist in other countries, making the omissions of insiders more like the omission of a landlord than the omission of the supposedly devoted sister.

It seems that the relationship between Japanese insiders and shareholders is not one in which directors have a very high duty to shareholders. Japan has a notorious reputation as a place where corporate directors do not have to be very responsive to shareholders. Though the Commercial Code in Japan offers similar protections to United States corporate law, "Japanese administrative agencies interpreting and applying the Code provide only modest shareholder protection, while Japanese courts offer few shareholder safeguards."<sup>149</sup> In 1989, American investor T. Boone Pickens complained that Japan needed to broaden shareholder rights if the country wished to attract foreign investors.<sup>150</sup> Even when Japanese law does provide for shareholder rights, Japanese shareholders often cannot realize those rights because "legal remedies for enforcing shareholder rights are relatively undeveloped in

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147. See *supra* Part II.B.3.

148. See Hendrik F. Jordaan, *A Comparative Analysis of Corporate Fiduciary Law: Why Delaware Should Look Beyond the United States in Formulating a Standard of Care*, 31 INT'L LAW. 133 (1997).

149. *Id.* at 153.

150. See Mashayoshi Kanabayashi & Marcus W. Brauchli, *Japan Shareholder Debate Erupts As 2 Firms Join to Fend Off Suitor*, WALL ST. J., Jul. 19, 1989, at A10.

Japan."<sup>151</sup> For example, unlike in the United States, there are no class action suits and plaintiffs cannot hire lawyers on a "contingency fee" basis.<sup>152</sup>

Also, Japanese directors are often thought to have loyalty to corporate employees over their own shareholders. A recent note summarized the phenomenon as follows:

Japanese directors are bound to the corporation and its employees by a moral element that may be as important as the duties imposed by the Code. Larger Japanese companies frequently guarantee lifetime employment, and directors evaluate the consequences of corporate decisions by the welfare of the employees. Moreover, in the context of bids for control, some commentators have suggested that because directors typically are lifetime employees and rarely major shareholders, they may subordinate the interests of shareholders to the needs of employees.<sup>153</sup>

Thus, in Japan, an insider's role may be more to protect the interests of the corporation's employees, than to further the interest of shareholders.

Canada, on the other hand, does not seem to lack in its enforcement of shareholder rights or broad duties of corporate insiders to shareholders. The Canada Business Corporations Act broadly prohibits any corporate action that "is oppressive or unfairly prejudicial to or that unfairly disregard[s] the interests of any security holder, creditor, director, or officer . . . ."<sup>154</sup> Shareholders have been able to bring actions under this act in court if they find corporate insiders have acted contrary to their interests.<sup>155</sup> Given these facts, it is unsurprising that Canadians are more disturbed by insider trading than the Japanese. Unlike in Japan, being an insider in Canada is more defined by one's duty to the shareholders.

*B. The Corporate Connections of Investors in Japan and Canada May Decrease the Duties of Corporate Insiders To Shareholders*

Insider trading laws prohibit insiders from taking advantage of their privileged position at the expense of shareholders. What was so disturbing about the *Wynn* case was that Hilda Wynn took advantage of information that she was given access to only by virtue of being placed in a position of trust and confidence. However, in both Japan and Canada, typical shareholders have access to information similar to that of corporate insiders. Hence, when insiders use information, they cannot quite as easily be said to be exploiting a position of trust and confidence. Many traders have access to inside information, so people may not think of insiders as

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151. M. Evan Corcoran, *Foreign Investment and Corporate Control in Japan: T. Boone Pickens and Acquiring Control Through Share Ownership*, 22 LAW & POL'Y INT'L BUS. 333, 340 (1991).

152. *Id.* at 340 n.55.

153. See Jordaan, *supra* note 148, at 153 (citations omitted).

154. Canadian Business Corporation Act, R.S.C., ch. C-44, § 241 (1985) (Can.).

155. See Deborah H. Demott, *Oppressed But Not Betrayed: A Comparative Assessment of Canadian Remedies for Minority Shareholders and Other Corporate Constituents*, LAW & CONTEMP. PROBS., Winter 1993, at 181, 186-93.

being entrusted with access to unique information or as exploiting an entrustment for a profit.

### 1. Japan

In Japan, nearly all traders are large companies with close ties to the companies in which they hold stock. While the typical trader in the United States likely has no ties to the corporations in which she holds stock, Japanese investors are usually large companies that deal often with other insiders.<sup>156</sup> In fact, interaction between companies is especially close in Japan where "the large, modern Japanese enterprise's relations with competitors and affiliates are organized, controlled, and hierarchical in nature."<sup>157</sup> So, because Japanese traders have more access to inside information than American traders, a trade on such information may be less like fraud and more like savvy business practice. While a typical American trader would have no means of obtaining inside information, Japanese traders are usually in a position to exploit connections with corporate insiders.

The typical fraudulent evildoer, according to Justice Powell, used his access to information, which was given in trust and confidence, to take advantage of the party that gave him that access. Insider trading does not fit this mold in Japan where traders are usually sophisticated, well-developed companies, many of which often offer "[b]ankers, brokers, favoured customers and large shareholders . . . privileged access to corporate information."<sup>158</sup> It seems that the typical victim of insider trading — the duped, unwitting outsider — is less present in Japan. Indeed, shareholding in Japan is practiced only by a relatively small number of elite businesspeople. Only seven percent of Japanese citizens own stock, compared with twenty percent of American citizens.<sup>159</sup> Due to the makeup of shareholders in Japan, as well as the relative equality of access to information between insiders and shareholders, insider trading may be more akin to mildly unpleasant business practices than deviant and immoral behavior.

The obvious question is what about those outsider-shareholders without access to information? Are they not wronged when an insider takes advantage of her access to information? Perhaps the market in Japan is simply not structured for such

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156. Traders in Japan are very different than the traders in the United States. As of 1989, less than twenty percent of issued shares in Japan were held by individual shareholders. Business corporations held thirty percent and financial institutions (banks and insurers) held forty-four percent. See Henderson, *supra* note 5, at 282-83. Though about seventy percent of United States stocks are also held by institutions, these institutions are usually pensions and mutual funds which serve individual investors. In Japan, however, the institutions that own stocks in particular companies are usually closely related "sister corporations." *Id.* That is, most of the corporate stock of any given Japanese corporation is held by other corporations who are in similar fields. Thus, Japanese stockholders are a uniform, unchanging group of sophisticated business organizations. One scholar has argued that Japanese companies tacitly hold each other's stocks in order to "effectively remove" shares from the market, to keep each company free from outside shareholder influence on management, and to prevent acquisition by foreign interests. See *id.* at 283 & n.72.

157. *Id.* at 290.

158. Sanger, *supra* note 51, at D1.

159. See Kattoulas, *supra* note 55.

people and they have fair warning that they should not be stockholders. American attorneys Harvey Pitt and David Hardison observed that "securities transactions in Japan traditionally have been considered risky investment[s] appropriate for sophisticated investors with close ties to securities markets."<sup>160</sup> People without access to information do not traditionally engage in trading in Japan because they know that individuals with no connections to any corporations are not well equipped to participate.

## 2. Canada

Much like in Japan, stockholders in Canada are likely to have many close connections with the corporations in which they hold stock. Most Canadian corporations are controlled by a single stockholder or a group of stockholders who have substantial influence over how the company is run. Professors Ronald Daniels and Jeffrey MacIntosh observed this phenomenon:

One of the most distinctive features of Canadian capital markets is the high degree of concentration of share ownership. Only 14[%] of the companies that make up the TSE 300 Composite Index are widely held. Of the remainder, 60.3% are owned by a single shareholder with legal control [and] 25.4[%] are owned either by one shareholder with effective control . . . or by two or three shareholders . . . having the ability to combine and establish joint legal or effective control.<sup>161</sup>

Furthermore, those exercising control of these companies are a group of experienced corporate insiders. Professor Deborah Demott has noted that "in 1985, . . . nine families were reported to control 46% of the top 300 companies traded on the Toronto Stock Exchange" (TSE).<sup>162</sup> Since stock is not usually widely held in Canada, stockholders are rarely disconnected outsiders like in the United States. Canadian shareholder blocks closely monitor corporate managers and are able to fire those that are suspected of promoting their own interests over the interests of the corporation.<sup>163</sup> Shareholders in Canada usually closely watch the operation of the business and, unlike the United States, could not be said to be entrusting corporate officials with access to much information that is not already available to stockholders.

Further, those that do own large blocks of stock likely allot each other access to information. Professor Demott noted that the nine families that own nearly half of the stock on the TSE often own shares in each other's empires. A news article observed that

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160. Pitt & Hardison, *supra* note 7, at 217.

161. Ronald J. Daniels & Jeffrey G. MacIntosh, *Toward a Distinctive Corporate Law Regime*, 29 OSGOODE HALL L.J. 863, 884 (1991).

162. Deborah A. Demott, *Corporate Dimensions of Takeover Regulation*, 65 WASH. U. L.Q. 69, 74 (1987).

163. See Daniels & MacIntosh, *supra* note 161, at 884-85.

[c]orporate Canada is, if anything, a vast web of interlocking companies owned by a handful of wealthy families — the Bronfmans, the Reichmans and Belzbergs, for example. Typically, one family group takes stakes in the operations of another and puzzling out who owns what, and where profits or losses do or don't flow from, is akin to peeling away layers of a proverbial onion.<sup>164</sup>

And those who are not on the "inside track" with such companies have avoided becoming shareholders in the first place. A Canadian money manager remarked that his philosophy with the companies owned by a certain family dynasty has been "to avoid them because I can't figure them out, even with 40 years' investment experience . . . I don't understand the ins and outs of the money, the preferred stocks. They are not things you can follow up the ladder."<sup>165</sup> A Montreal manager similarly stated, "[w]e don't invest in these companies simply because we don't always understand how everything fits together."<sup>166</sup>

Typical Canadian stockholders do often have access to information regarding corporations in which they hold stock. Because stockholders in Canada often have ease of access to corporate information, it is less true that an insider has been entrusted with access to information in the strictest of confidence. Shareholder access does not rise to the level that it does in Japan, where releasing information often occurs in the course of business relationships, but the access of Canadian and Japanese shareholders far exceeds the access of their counterparts in the United States where traded shares are usually widely held by a disparate group of stockholders with little connection to the corporation. Hence, we should not be surprised that the abuse of access to information through insider trading is more objectionable in Canada than in Japan, and more objectionable in the United States than in Canada.

### *C. Varying Protocols Regarding Disclosure of Firm-Related Information Likely Alter the Duties of Insiders*

The relationship between corporate insiders and shareholders is usually one that includes disclosure of different sorts of information about the corporation. It seems possible that if corporate duties do not typically include informing shareholders of the ins and outs of the corporation, they may also not include disclosing material information before trading on inside information. An example will help illustrate. Imagine that an American trader named Annette is interested in buying General Motors (GM) stock. Annette considers one of two options. She may call her stockbroker, Wendell, and ask him to buy her 200 shares of GM. Annette thinks of Wendell as she thinks of a waiter at a restaurant. She orders stocks and Wendell gets them for her. They never discuss anything further than which stocks Annette wants. Annette may also call her other stockbroker, Harry, and ask him to buy her

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164. Clyde H. Farnsworth, *The Bronfmans' Leveraged Leviathan*, N.Y. TIMES, May 24, 1992, at A1.

165. *Id.*

166. Suzanne McGee, *Bronfmans' Giant Edper Empire Circles the Wagons*, WALL ST. J., Dec. 2, 1992, at B6.

200 shares of GM. Harry is always brimming with information about what is hot and what is not. He always speaks liberally with Annette about what stocks people are talking about before Annette makes her final purchase decision. Imagine further that both stockbrokers have heard that GM stock is really a bad buy at the moment. When Annette orders the GM stock from Harry, she would likely expect that he would relay any information he had about the stock she was buying. After all, Harry has served as a source of information in the past, so when he has information that will be especially important to her, Annette would expect Harry to mention it. However, Wendell has never been a source of information at all. Just like Annette would not expect her waiter to tell her if he had just read an article that claimed the dish she was ordering was less healthy than previously thought, she would not expect Wendell to suddenly question her decision to buy GM stock.

The varied approaches of these two fictional stockbrokers resembles the difference between the United States and countries like Japan and Canada. Because Japan and Canada generally require less disclosure of corporate related information than in the United States, it is possible that corporate insiders in those countries are more like Wendell than like Harry. That is, it is possible Japanese and Canadian insiders have less of a duty to disclose certain information than their American counterparts.

### 1. Japan

Legally, Japanese companies are not required to disclose nearly as much information as their American counterparts.<sup>167</sup> Professor Mark West explains some of the differences between what American corporations are legally required to disclose to the public and what Japanese corporations are required to disclose to the public:

A review of a Japanese corporation's annual report (*yuka shoken hokokusho*) in comparison to a United States report reveals some prominent differences. First, a Japanese report contains no mention of management compensation as required in the United States. Second, Japanese reports do not break down sales by industry or business line, so it is difficult to determine a firm's profitability. Third, assets a Japanese firm holds in the form of securities are booked at the price of which the firm bought shares, and not the current market price. Finally, a Japanese financial statement usually is not specific about the method the company uses to depreciate its assets.<sup>168</sup>

West further explains that Japanese corporations also voluntarily disclose information much less than United States companies.<sup>169</sup> It seems less common for

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167. See Jonathan Macey & Hideki Kanda, *The Stock Exchange as Firm: The Emergence of Close Substitutes for New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1015 (1990).

168. Mark D. West, *Corporate Law, Corporate Governance, and Corporate Extortion in the United States and Japan*, 93 NW. L. REV. 767, 779 (1999).

169. See *id.* at 781.

corporations to give firm-related information to shareholders in Japan even though that disclosure would clearly help investors make more informed choices about trading.

This lack of disclosure suggests that if Japanese insiders have a fiduciary duty to shareholders, the legal duty does not encompass as much information disclosure as in the United States. Note that regularly disclosed information about firms is used to assess the profitability of a stock. Because Japanese corporations are not required to reveal this information — despite its relevance to determining profitability of a security — it seems they do not have a high duty to disclose inside information before trading.

Basically, because Japanese laws do not require disclosure of much information from corporations, corporate insiders in Japan are more like Wendell than like Harry. They, like Wendell, are not generally expected to be the source of information, so it is less objectionable when corporate executives do not reveal inside information to stockholders. Certainly, Annette would have appreciated if Wendell had offered his information about GM stock, but owing to his past behavior and her resulting expectations, she cannot blame him much for not doing so. Similarly, stockholders do not consider Japanese corporations to be a source of information about the profitability of stocks and may not think it that shocking when insiders omit especially useful inside information.

Meanwhile, American corporations are more like Annette's information-wielding stockbroker, Harry. While Japanese corporations fail to disclose much of information stockholders could use to assess profitability, in the United States "mandatory disclosure requirements are far more demanding in breadth and detail than those of Japan and other developed countries."<sup>170</sup> If Harry always offered information, but suddenly omitted highly specific, extremely relevant information the one time he thought he had something to gain by keeping quiet, we would find his omission morally suspect. Similarly, American companies are our source of information for assessing the profitability of stocks. It follows that the directors of that corporation have taken on a fiduciary duty to provide us with such information, especially when they know material facts that will drastically affect the price of the stocks we are buying or selling.

## 2. Canada

If the amount of firm-related disclosure expected coincides with the degree of wrongness of insider trading, then it is not surprising that the laws of Canada require more disclosure than Japan. However, Canada's disclosure requirements still fall short of the requirements imposed in the United States.

Professor Cally Jordan has noted that disclosure requirements in Canada and the United States are similar enough to be considered "close cousins."<sup>171</sup> But there are

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170. James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 HASTINGS INT'L & COMP. L. REV. 149, 149 (1993).

171. Jordaan, *supra* note 148, at 584.



subtle differences suggesting disclosure is a less integral part a corporation's relationship with its stockholders in Canada than in the United States. Unlike in the United States, Canadian Commissions generally have the power to exempt a firm from the prospectus requirements if it is in the public interest.<sup>172</sup> There are also certain specific facts about firms that must be divulged in the United States, but not in Canada, such as certain details about executive compensation.<sup>173</sup> Issuers in Canada often complain that "U.S.-style" disclosure is "unnecessarily burdensome."<sup>174</sup>

Hence, the relationship between insiders and shareholders in Canada revolves around disclosure, and Canadian shareholders may feel they have a right to expect that insiders reveal highly relevant information when trading with them. However, an omission of pertinent information by a Canadian corporation is still probably less objectionable than it would be in the United States where insiders are expected to disclose nearly any relevant firm-related facts to their shareholders.

### V. Conclusion

Insider trading has been a bit of a puzzle. Professor Leo Katz has noted that, though most people think insider trading is wrong, they cannot quite articulate why.<sup>175</sup> While the United States Supreme Court has steeped its objections in unfairness and comparisons to fraud, others have suggested that we should look more closely at amoral economic effects on markets. One scholarly work called into question

the legitimacy of the often summarily accepted proposition that insider trading is[] in fact bad for both markets and investors in light of robust capital markets that exist in places like Japan, Hong Kong, Singapore, and Germany where insider trading has long been de facto or de jure legal.<sup>176</sup>

Others have dismissed fairness-based opposition to insider trading as too "vague and ill-informed."<sup>177</sup> Nonetheless, we cannot ignore the intuitions of many that insider trading is, as one observer put it, "just not right."<sup>178</sup> Even if we found that insider trading was economically efficient, many would "continue to abhor it [because] it feel[s] unfair."<sup>179</sup>

It is important that we examine the content of this moral intuition before making conclusions about how the laws should govern insider trading. If we find insider

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172. See *id.* at 585.

173. See *id.* at 594.

174. *Id.*

175. See KATZ, *ILL-GOTTEN GAINS*, *supra* note 104, at 171.

176. Enrico Colunbatto & Jonathan R. Macey, *A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 CARDOZO L. REV. 925, 948 (1996).

177. Jonathan R. Macey, *From Fairness to Contract: The New Directions of Rules to Insider Trading*, 13 HOFSTRA L. REV. 9, 10 (1984).

178. Scheppelle, *supra* note 2, at 123.

179. KATZ, *ILL-GOTTEN GAINS*, *supra* note 104, at 173.

trading as devious as fraud, we should not allow the activity to continue unpunished even if we find that it is economically efficient. Also, just as the efficiency of a practice differs depending on elements of a particular economy, the morality of complex activities may depend on where that activity is taking place. While most feel a core moral distaste for fraud, this article has suggested that such distaste need not extend to insider trading in Japan, Canada, or any other country even if moral intuitions compel punishment of fraud in those countries. In recent years, the United States has put pressure on other countries to punish inside traders in the same way they are punished in the United States.<sup>180</sup> The United States' influence has helped bring about some arrests<sup>181</sup> as well as some prison sentences.<sup>182</sup> For the most part, however, such pressures have been met with limited changes or enthusiasm.<sup>183</sup> The illegality of insider trading has always been based on beliefs that the offenders were unfair and devious. But those beliefs are based on distinctive characteristics of United States securities markets. Just because industrialized nations accept that fraudulent business dealings are immoral, it does not follow that the complex and complicated practice of insider trading is always immoral.

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180. See Arkin, *supra* note 48, at 3.

181. See *Japan Executive Held in Insider Trading Case*, ASIAN WALL ST. J., July 7, 1995; see also *supra* Part II.

182. See JAPAN WEEKLY MONITOR, *supra* note 4; see also *supra* Part II.

183. See *supra* Part II.

